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TO SECSTATE WASHDC 7997

INFO AMCONSUL RIO DE JANEIRO

AMCONSUL SAO PAULO

C O N F I D E N T I A L SECTION 1 OF 5 BRASILIA 4921

EO 11652: GDS

TAGS: EFIN, BR

SUBJ: MONETARY TRENDS AND DEVELOPMENTS

REFS: A) BRASILIA 8721 (77), B) BRASILIA 9998 (77)

C) BRASILIA 10176 (77), D) BRASILIA 0904, E) BRASILIA 3447,

F) BRASILIA 4049, G) BRASILIA 4460

1. SUMMARY. THE SHARP REDUCTION IN THE RATE OF INFLATION IN BRAZIL IN THE SECOND HALF OF 1977 WAS AT LEAST IN PART ATTRIBUTABLE TO MONETARY RESTRAINTS IMPOSED 6-8 MONTHS EARLIER. HOWEVER, DESPITE FURTHER CONTRACTIONARY MEASURES ADOPTED IN LATE 77, BANK OF BRAZIL LENDING REPASSES FROM THE CENTRAL BANK RESULTED IN MONETARY EXPANSION WELL IN EXCESS OF THE GOB'S MONETARY BUDGET FOR 1977. FURTHER UNEXPECTEDLY HIGH INFLOWS OF FOREIGN EXCHANGE IN EARLY 1978 AND A NEED FOR SPECIAL DROUGHT RELIEF CAUSED THE GROWTH IN BOTH MONEY SUPPLY AND THE MONETARY BASE TO EXCEED THE NEW 1978 TARGETS BY THE END OF MAY. THESE TWO FACTORS PLUS PERHAPS EXCESSIVE RELIANCE BY THE MONETARY AUTHORITIES ON OPEN MARKET OPERATIONS AS AN INSTRUMENT OF MONETARY CONTROL AGGRAVATED OTHER PROBLEMS SUCH AS RISING INTERNAL PUBLIC DEBT, LAGGING HOUSING CONSTRUCTION FINANCE, AND RISING INTEREST RATES.

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THE MONETARY AUTHORITIES HAVE SUCCESSFULLY CONTROLLED TOTAL LENDING BY THE BANK OF BRAZIL AND HAVE ADOPTED SEVERAL MEASURES TO MAINTAIN RESTRAINT ON COMMERCIAL BANK OPERATIONS, TO ENCOURAGE SAVINGS DEPOSITS, AND TO REDUCE THE INVOLVEMENT OF BANKS IN THE OPEN MARKET. THE AUTHORITIES ACKNOWLEDGE THAT CIRCUMSTANCES HAVE MADE UNATTAINABLE THEIR ORIGINAL TARGET OF 25 PERCENT MONETARY EXPANSION IN 1978. THEY CURRENTLY BELIEVE THAT 35

PERCENT IS A REASONABLE AND REALISTIC OBJECTIVE. THE EFFECT OF THE DROUGHT ON FOOD SUPPLIES AND PRICES AND ON THE CREDIT REQUIREMENTS OF THE AGRICULTURAL SECTOR THUS HAVE PRECLUDED ANY SIGNIFICANT IMPROVEMENT IN MONETARY PERFORMANCE AND INFLATION IN 1978. THE EMBASSY, IN FACT, WOULD NOT BE SURPRISED TO SEE EITHER OR BOTH OF THESE MEASURES REACH 40 PERCENT. RECOVERY OF AGRICULTURAL PRODUCTION IN 1979, HOWEVER, SHOULD PERMIT A RETURN TO MORE SATISFACTORY TRENDS AND PERHAPS EVEN PROGRESS TOWARD REDUCING THE HEAVY SUBSIDIZATION OF AGRICULTURAL CREDIT. END SUMMARY.

2. 1977 RESULTS. BRAZIL'S MONETARY AUTHORITIES ADOPTED POLICIES IN LATE 1976 THAT WERE EXPLICITLY AIMED AT COOLING OFF ECONOMIC ACTIVITY AND REDUCING THE RATE OF INFLATION. THESE POLICIES INCLUDED REMOVAL OF CEILINGS ON MOST INTEREST RATES AND REDUCTION IN CONSUMER FINANCING AND CONTRIBUTED TO THE REDUCTION IN INFLATION IN THE SECOND HALF OF 1977. HOWEVER, IN THE LAST FOUR MONTHS OF THE YEAR SEVERAL FACTORS CONTRIBUTED TO EXCESSIVE MONETARY EXPANSION WHICH RESULTED IN 37.6 PERCENT INCREASE IN THE MONEY SUPPLY IN CY 1977 IN CONTRAST TO THE MONETARY BUDGET TARGET OF 25 PERCENT. THE FACTORS THAT COMPLICATED MONETARY MANAGEMENT INCLUDED: THE HIGH COST OF AGRICULTURAL SUBSIDY PROGRAMS ASSOCIATED WITH VERY GOOD GROWTH IN PRODUCTION; UNEXPECTED LARGE-SCALE CONVERSION OF GOVERNMENT BONDS HELD BY STATE ENTERPRISES; SUBSTANTIAL INFLOWS OF FOREIGN EXCHANGE RELATED TO THE FIRST TRADE SURPLUS SINCE 1970 AND CONTINUED

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LARGE-SCALE FOREIGN BORROWING (REF B). THE MONETARY AUTHORITIES RESPONDED IN OCTOBER WITH INCREASES IN THE COMPULSORY RESERVE REQUIREMENT FOR THE COMMERCIAL BANKS FROM 35 TO 40 PERCENT AND IN THE CENTRAL BANK REDISCOUNT RATE FROM 28 TO 30 PERCENT. THEY ALSO TOOK MEASURES

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TO ENCOURAGE REPURCHASE OF GOVERNMENT BONDS AND TO RESTRAIN LENDING BY THE BANK OF BRAZIL (REF A). IN NOVEMBER THE GOVERNMENT TEMPORARILY STERILIZED THE CRUZEIRO COUNTERPART GENERATED BY INFLOWS OF FOREIGN LOANS (REF C). EXPANSION OF CREDIT BY THE BANKING SYSTEM WAS LESS IN 1977 (51.2 PERCENT) THAN IN 1976 (56.5 PERCENT) BUT DESPITE THE MEASURES ADOPTED LATE IN THE YEAR BANK LENDING STILL GREATLY EXCEEDED THE MONETARY BUDGET TARGETS. LOANS TO THE PRIVATE SECTOR FROM THE BANK OF BRAZIL INCREASED 48.7 PERCENT AND FROM THE COMMERCIAL BANKS 52.4 PERCENT, COMPARED TO THE TARGETS OF 33 PERCENT AND 35 PERCENT, RESPECTIVELY. THE MONETARY BASE (DEFINED AS TOTAL MONETARY LIABILITIES, CONSISTING OF CURRENCY IN CIRCULATION, COMMERCIAL BANK DEPOSITS WITH THE CENTRAL BANK, AND SIGHT DEPOSITS IN THE BANK OF BRAZIL) EXPANDED 50.8 PERCENT IN 1977 AND THUS EXCEEDED BOTH THE INCREASE OF 49.9 PERCENT IN 1976 AND THE 1977 MONETARY BUDGET TARGET OF 36 PERCENT. THE ELEMENTS WHICH DEPARTED MOST FROM EXPECTATIONS WERE MUCH GREATER BANK OF BRAZIL CREDIT FOR AGRICULTURE (INCLUDING ESPECIALLY THE 85 PERCENT INCREASE IN OUTLAYS FOR THE MINIMUM PRICE PROGRAM AND MORE THAN DOUBLE THE LEVEL OF FINANCING FOR COFFEE) AND REPASSES OF FUNDS FROM THE CENTRAL BANK ESPECIALLY IMPORTANT IN TERMS OF GROWTH WERE A 99 PERCENT

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INCREASE IN TRANSFERS FROM PASEP TO THE BNDE AND INCREASED EXPORT FINANCING). ALSO CONTRIBUTING IN DEVIATION FROM THE MONETARY BUDGET WERE LOWER THAN EXPECTED INCREASES IN NON-MONETARY LIABILITIES SUCH AS THE NET POSITION OF THE GOB TREASURY, THE COFFEE ACCOUNT AND PRIOR IMPORT DEPOSITS.

3. 1978 MONETARY BUDGET. THE MONETARY BUDGET TARGETS FOR 1978 CALLED FOR FURTHER CONTRACTIONARY POLICIES TO REDUCE AGGREGATE DEMAND AND INFLATION (REF D). BOTH MONEY SUPPLY AND THE MONETARY BASE WERE PROJECTED TO INCREASE BY 25 PERCENT DURING THE YEAR, ASSUMING NO CHANGE IN THE MULTIPLIER AS DETERMINED BY THE LIQUIDITY PREFERENCES OF THE PUBLIC. THE CORRESPONDING PROJECTION OF MONETARY GROWTH BASED ON THE AVERAGE LEVEL OF MONEY SUPPLY DURING THE YEAR WAS 32 PERCENT, IN COMPARISON WITH 38 PERCENT IN 1977M TOTAL LOANS OF THE BANKING SYSTEM WERE PROJECTED TO INCREASE

BY 31-32 PERCENT, WITH BANK OF BRAZIL EXPANDING 27 PERCENT
AND COMMERCIAL BANKS 35 PERCENT. THE PROPOSED BANK OF BRAZIL
LENDING IMPLIED CONSIDERABLE RESTRAIN ON NORMAL LOANS TO BOTH
THE PRIVATE AND PUBLIC SECTORS AS WELL AS MUCH LOWER
GROWTH OF OUTLAYS THAN IN 1977 FOR THE MINIMUM PRICE PROGRAM
AND THE COFFEE FUND. IN ORDER TO BETTER ASSURE DISCIPLINE
ON THE PART OF THE BANK OF BRAZIL, THE MONETARY BUDGET PROVIDED
FOR THE FIRST TIME FOR THAT INSTITUTION TO PAY TO THE CENTRAL
BANK A PENALTY EQUIVALENT TO THE REDISCOUNT RATE FOR COMMERCIAL
BANKS WITH RESPECT TO ANY NORMAL LENDING IN EXCESS OF THE
ESTABLISHED LIMITS. REPASSES FROM THE MONETARY AUTHORITIES
TO FINANCIAL INSTITUTIONS WERE ALSO PROJECTED TO INCREASE
MUCH LESS IN 1978 (28 PERCENT) THAN IN 1977 50 PERCENT),
INCLUDING RELATIVE RESTRAINTS ON FUNDS FOR EXPORT FINANCING AND
THE BNDE AS WELL AS FOR FUNAGRI AND PROTERRA. THE ATTEMPT
TO RESTRAIN THE GROWTH OF ASSETS OF THE MONETARY AUTHORITIES
IN 1978 WAS PROMPTED IN PART BY EXPECTATIONS OF RELATIVELY
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LITTLE INCREASE IN OFFSETTING NON-MONETARY LIABILITIES.
NET RESOURCES OF THE TREASURY IN THE HANDS OF MONETARY AUTHORITIES
WERE PROJECTED TO REMAIN UNCHANGED AND PRIOR IMPORT DEPOSITS WERE
EXPECTED TO RISE ONLY marginally OWING TO RELEASE OF MATURED
DEPOSITS AND INCREASING EXEMPTIONS FOR VARIOUS IMPORTS. THE
NET RESULT OF SHIFTS IN BANK OF BRAZIL LENDING AND CONTINUATION
OF THE REQUIREMENT THAT COMMERCIAL BANKS APPLY A MINIMUM
OF 15 PERCENT OF THEIR DEPOSITS TO AGRICULTURE WAS TO BE A
32 PERCENT INCREASE IN CREDIT TO AGRICULTURE IN 1978 COMPARED
TO 48 PERCENT IN 1977. CREDIT FOR NON- AGRICULTURAL ACTIVITIES
WAS TARGETED AT 31 PERCENT INCREASE, COMPARED TO 63 PERCENT
IN 1977. THE FINANCE MINISTER STRESSED THE FLEXIBILITY OF THE

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MONETARY BUDGET, POINTING OUT THAT MONOR DEVIATIONS WOULD BE DEALT WITH BY MEANS OF OPEN MARKET OPERATIONS AND MORE FUNDAMENTAL UNEXPECTED DEVELOPMENTS WOULD REQUIRE ADJUSTMENTS IN OTHER ELEMENTS OF THE MONETARY PROJECTIONS.

4. PERFORMANCE THROUGH APRIL-MAY. ACTUAL TRENDS IN MONETARY AGGREGATES IN JANUARY MAY 1978 ALREADY HAVE REFLECTED CONSIDERABLE DEVIATION FROM THE AUTHORITIES EXPECTATIONS AT THE BEGINNING OF THE YEAR. MONEY SUPPLY GROWTH WAS 4.0 PERCENT AND THE MONETARY BASE INCREASED 5.8 PERCENT THROUGH MAY. IN BOTH CASES THESE RESULTS EXCEEDED THE MONETARY BUDGET TARGETS OF 1.6 PERCENT AND 2.7 PERCENT, RESPECTIVELY. THE SINGLE MOST IMPORTANT DEVIATION FROM THE TARGETS WAS A 47 PERCENT HIGHER LEVEL IN THE MONETARY AUTHORITIES FOREIGN ACCOUNT AT THE END OF MAY THAN WAS EXPECTED. THIS DEVELOPMENT WAS RELATED IN PART TO THE RELEASE IN JANUARY-FEBRUARY OF FOREIGN LOANS IN EXCESS OF \$1 BILLION THAT ENTERED IN BRAZIL IN LATER 1977 AND WRE TEMPORARILY STERILIZED. IN ADDITION, THE IMPROVEMENT IN BORROWING TERMS FOR BRAZIL IN ADDITION, THE IMPROVEMENT IN BORROWING TERMS FOR BRAZIL IN THE EURO-DOLLAR MARKET PROMPTED GREATER BORROWING ESPECIALLY BY STATE ENTERPRISES AND THE GOB ITSELF IN EARLY 1978 COMPARED TO PREVIOUS YEARS. AFTER AN INITIAL SMALL DECLINE, THE REBOUND
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IN FOREIGN RESERVES TO ABOUT \$7.5 BILLION AT THE END OF MAY WAS REFLECTED MAINLY BY A SHARP INCREASE IN SIGHT DEPOSITS IN THE BANK OF BRAZIL (REF G). THE INCREASE IN BANK OF BRAZIL DEPOSITS WAS THE MAIN FACTOR IN THE EXCESSIVE GROWTH IN THE MONETARY BASE BUT IT DID NOT RESULT IN UNEXPECTEDLY RAPID INCREASE IN LENDING. THE BANK OF BRAZIL ADHERED TO THE DISCIPLINE OF THE MONETARY BUDGET AND IN FACT THROUGH MAY THE 9.2 PERCENT INCREASE IN IT LOANS WAS BELOW THE 10.6 PERCENT PERMITTED BY THE TARGET. ON THE OTHER HAND, COMMERCIAL BANKS LOANS INCREASED 18.3 PERCENT IN CONTRAST TO THE TARGET OF 10.8 PERCENT, LARGELY ON THE BASIS OF A 46 PERCENT INCREASE IN TIME DEPOSITS. SINCE THE COMMERCIAL BANKS ACCOUNT FOR OVER ONE-HALF OF TOTAL OUTSTANDING LOANS OF THE BANKING SYSTEM, THEIR INCREASED LENDING RESULTED IN OVERALL CREDIT EXPANSION IN EXCESS OF THE MONETARY BUDGET PROJECTION(14.3 PERCENT COMPARED TO 10.6 PERCENT) AND IN MAINTENANCE BY THE MONETARY AUTHORITIES OF A SLIGHTLY HIGHER LEVEL OF CURRENCY IN CIRCULATION THAN WAS ORIGINALLY INTENDED.

5. NATURE OF THE PROBLEMS - DROUGHT RELIEF. THE SHORTFALL FROM MONETARY TARGETS TO DATE IS MAINLY ATTRIBUTABLE TO THE INFLOW OF FOREIGN EXCHANGE AS BRAZIL HAS TAKEN ADVANTAGE OF FAVORABLE MARKET CONDITIONS TO ASSURE ADEQUATE FINANCING FOR THE ANTICIPATED INCREASE IN THE CURRENT ACCOUNT DEFICIT BY THE END OF 1978. THE ORIGINIAL ASSUMPTION OF AN OVERALL BALANCE OF PAYMENTS EQUILIBRIUM OR ONLY SMALL SURPLUS IS STILL PROBABLY VALID HOWEVER, AND THUS THE FOREIGN EXCHANGE IMPACT ON MONETARY AGGREGATES IS EXPECTED TO RETURN TO PROJECTED LEVELS IN COMING MONTHS. HOWEVER, OTHER PROBLEMS HAVE ARISEN TO FURTHER COMPLICATE THE LACK OF MONETARY MANAGEMENT. MOST OBVIOUS IS THE SEVERE DROUGHT IN THE CENTER SOUTH, WHICH HAS SERIOUSLY AFFECTED AGRICULTURAL PRODUCTION AND EMPLOYMENT AND REQUIRED SPECIAL REMEDIAL ACTION. IN APRIL-MAY THE GOB EXTENDED THE MATURITY

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ON FARMERS'DEBT, PROVIDED SPECIAL CREDIT WHERE MOST NEEDED, AND DECIDED TO SPEED UP RELEASE OF FUNDS FOR URBAN PUBLIC WORKS PROJECTS IN THE AFFECTED STATES (REF E AND F). THE AUTHORITIES POSTPONED THE PLANNED RELEASE OF THE 5 PERCENT ADDITIONAL COMPULSORY RESERVE REQUIREMENT ESTABLISHED IN LATE 1977 AND ALSO IMPOSED ADDITIONAL RESTRAINTS ON BANK OF BRAZIL LENDING IN ORDER TO COMPENSATE FOR THE EXPANSION OF AGRICULTURAL CREDIT. HOWEVER, THE EXTEND OF THE DROUGHT DAMAGE IS NOT YET CLEAR AND MAY STILL REQUIRE FURTHER DEVIATION FROM THE MONETARY BUDGET PROJECTIONS.

6. RISING INTEREST RATES. DOMESTIC INTEREST RATES TRENDED DOWNWARD ALONG WITH INFLATION IN THE SECOND HALF OF 1977 BUT HAVE RISEN AGAIN IN 1978. ALTHOUGH

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HIGHER RATES ARE IN PART A NATURAL CONSEQUENCES OF THE MONETARY MEASURE ADOPTED IN LATE 1977, THEY CONSTITUTE AN INCREASED COST TO BORROWERS AND THE ADVERSE EFFECT ON INVESTMENT IN PARTICULAR IS OF CONCERN TO THE AUTHORITIES. THE MINISTER OF FINANCE HAS STATED THAT THE RISE IN RATES IS UNNECESSARY AND INAPPROPRIATE; HOWEVER, THE MARKET IS RESPONDING TO SEVERAL FACTORS. THE MERE ANNOUNCEMENT OF THE MONETARY BUDGET TARGETS SUGGESTED MONETARY RESTRAINT AND COMBINED WITH INCREASED LOAN DEMAND ASSOCIATED WITH THE RECOVERY OF INDUSTRIAL ACTIVITY RESULTED IN UPWARD PRESSURE ON RATES. THERE ALSO WERE THE NORMAL SEASONAL FACTORS SUCH AS THE INITIAL REDUCTION IN FOREIGN RESERVES AND THE FACT THAT BANKS ARE OBLIGED TO INCREASE THEIR COMPULSORY RESERVES IN JANUARY IN CONNECTION WITH THE HIGH LEVEL OF SIGHT DEPOSITS THROUGH MAY IN FACT PERMITTED THE BANKS TO CONTINUE TO INCREASE THEIR LENDING BUT THE IMPLIED HIGHER OPERATIONAL COSTS ALSO INCURRED BANKS RAISE INTEREST RATES IN AN ATTEMPT TO MAINTAIN PROFIT SPREADS. FINALLY, AND PROBABLY MOST IMPORTANT, WAS THE ACCELERATION IN THE RATE OF INFLATION IN LATE 1977 AND EARLY 1978 AND THE ANTICIPATED FURTHER IMPACT OF FOOD SHORTAGES ON PRICE LEVELS.

7. OPEN MARKET OPERATIONS AND RISING INTERNAL DEBT. IN RECENT
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YEARS BRAZIL'S BRAZIL'S INTERNAL PUBLIC DEBT HAS BEEN RISING AT AN AVERAGE ANNUAL RATE OF 60 PERCENT AND REACHED CR\$240 BILLION AT THE END OF 1977. THIS INCREASE IN PUBLIC BORROWING BY MEANS OF FEDERAL MONEY INSTRUMENTS HAS NOT BEEN PROMPTED BY A NEED TO FINANCE STRICTLY FISCAL DEFICITS. THE FEDERAL TREASURY HAS CONSISTENTLY RECORDED SMALL SURPLUSES, INCLUDING IN THE FIRST FIVE MONTHS OF 1978. HOWEVER, THE TOTAL INTERNAL PUBLIC DEBT HAS RISEN LARGELY THROUGH THE INCREASED EMISSION OF SHORT-TERM TREASURY BILLS (LTN) WHICH HAS SERVED TWO ALTERNATIVE AND SOMEWHAT MUTUALLY EXCLUSIVE PURPOSES: FIRST, AS A MONETARY INSTRUMENT TO INFLUENCE (IE, USUALLY REDUCE) MARKET LIQUIDITY; SECOND, AS MEANS OF TRANSFERRING FUNDS FROM THE PRIVATE MARKET TO STATE ENTERPRISES AND OTHER PRIORITY END-USERS THROUGH THE SPECIAL CREDIT PROGRAMS OF THE CENTRAL BANK AND THE BANK OF BRAZIL. TO THE EXTENT THE FUNDS ARE NOT STERILIZED BUT PASSED BACK INTO THE ECONOMY, THE INITIAL CONTRACTIONARY EFFECT IS OF COURSE NEGATED. THE DATA INDICATED THAT THE MONETARY AUTHORITIES ARE CONTROLLING THEIR OWN LENDING PROGRAMS WITH THEIR

TARGETS OF 1978. HOWEVER, MINISTER SIMONSEN HIMSELF HAS STATED THAT THE OPEN MARKET, WHICH IS DOMINATED BY TREASURY BILLS, IS NOT ADEQUATE TO ABSORB THE BURDEN OF OFFSETTING MAJOR DEVIATIONS FROM THE PROJECTIONS OF THE MONETARY BUDGET. THE ATTEMPT TO SAOK UP EXCESS LIQUIDITY BY OPEN MARKET OPERATIONS HAS CAUSED UPWARD PRESSURE ON INTERESTS RAGES AND DISTORTIONS IN SAVINGS PATTERNS, AS WELL AS A DETERIORATION IN THE INTERNAL DEBT PROFILE. TREASURY BILLS (LTN) WITH MATURITIES RANGING FROM 91 TO 365 DAYS HAVE INCREASED AS A PROPORTION OF TOTAL FEDERAL PUBLIC INTERNAL DEBT FROM 31 PERCENT AT THE END OF 1974 TO 50 PERCENT AT THE END OF 1977 AND THIS TREND REPORTEDLY HAS CONTINUED INTO 1978. SINCE THE YIELD ON LTN VARIES WITH MARKET CONDITIONS, THE AUTHORITIES RECENT SALES POLICY HAS HELPED PUSH INTEREST RATES TO OVER 50 PERCENT. THIS ATTRACTIVE OPTION HAS DEFINITELY AFFECTED SHORT TERM RATES AND SOME
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FEEL IT HAS DRAWN RESOURCES ALSO AWAY FROM SAVINGS AND TIME DEPOSITS.

8. LAGGING HOUSING FINANCE. SAVINGS DEPOSITS IN THE SAVINGS AND LOAN ASSOCIATIONS HAVE DROPPED IN RECENT MONTHS AND CAUSED STAGNATION IN HOUSING FINANCE BY THE NATIONAL HOUSING BANK (BNH) AND THE CAIXA ECONOMICA. SAVINGS DEPOSITS IN THE NATIONAL HOUSING FINANCE SYSTEM ARE INDEXED AND BOTH DEPOSITS AND FINANCING OF CONSTRUCTIONS BOOMED IN MIRACLE YEARS OF 1968-73. THREE FACTORS PROBABLY HAVE IMPACTED NEGATIVELY ON AVAILABLE FINANCIAL RESOURCES FOR THIS LABOR-INTENSIVE INDUSTRY. WITH RESURGENCE OF INFLATION IN 1974-75 THE GOBSOUGHT TO

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MITIGAE THE FEEDBACK EFFECT OF INDEXING BY MODIFYING THE CONCEPT OF MONETARY CORRECTION SO THAT IT NO LONGER OFFSETS THE FULL AMOUNT BUT RATHER ONLY ABOUT 85 PERCENT OF PREVAILING INFLATION. AS A RESULT, BOTH INDEXED SAVINGS DEPOSITS AND GOB TREASURY BONDS (ORTN) LOST SOME OF THEIR ATTRACTIVENESS. DEPOSITS LEVELED OF OR DECLINED IN REALS TERMS, ESPECIALLY IN THE SECOND HALF OF 1977. WHEN DECLINE INFLATION IMPLIED EVEN LESS MONETARY CORRECTION. A SECOND FACTOR WAS THE LEBERATION OF MOST INTEREST RATES IN LATE 1976 WHICH PERMITTED COMMERCIAL BANKS TO COMPETER FOR SAVINGS BY OFFERING HIGHER RETURN ON TIME DEPOSITS. THIRDLY, AS MENTIONED ABOVE, THE INCREASING YIELDS ON LTN MAY ALSO HAVE HAD SOME ADVERSE EFFECT ON SAVINGS DEPOSITS.

9. GOB MEASURES. THE MONETARY AUTHORITIES HAVE TAKEN SEVERAL ACTIONS IN 1978 IN RESPONSE TO THE EXCESSIVE EXPANSION AND OTHER PROBLEMS DISCUSSED ABOVE, IN ADDITION TO THE PROVISION OF EMERGENCY DEBT RELIEF AND SPECIAL CREDIT FOR AGRICULTURE, OFFSET BY EXTENSIVE OF THE 5 PERCENT EXTRA RESERVE REQUIREMENT, THE AUTHORITIES CONFIRMED THAT THE AMOUNT OF COMPULSORY RESERVES THAT MAY BE HELD IN INTEREST BEARING ORTN WILL REMAIN FROZEN AT EH NOMINAL LEVEL IN EXISTENCE IN OCTOBER 1977. THIS IMPLIES A STEADILY DECLINING PROPORTION OF RESERVES IN ORTN
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AND AN INCREASING PROPORTION IN NONE-EARNING CASH DEPOSITS WITH THE CENTRAL BANK. IN MARCH 1978 THE AUTHORITIES MODIFIED THE MINIMUM MATURITY FOR TIME DEPOSITS FROM 30 DAYS TO 180 DAYS, WHICH HAS SLOWED DOWN THE RAGE INCREASE IN COMMERCIAL BANKS TIME DEPOSITS. ON THE OTHER HAND, THE AUTHORITIES ARE EXPECTED IN THE VERY NEAR FUTURE TO MODIFY THE MECHANISM APPLYING TO EXISTING COMPUSORY RESERVES IN ORDER TO PERMIT BANKS TO USE THEIR COMPULSORY RESERVES SO LONG AS THEY MAINTAIN ON AVERAGE THE REQUIRED LEVEL OF DEPOSITS OVER THE COURSE OF EACH MONTH. THIS INCREASED FLEXIBILITY IS NOT EXPECTED TO RESULT IN INCREASED BANK LENDING BUT IS IS HOPED IT WILL REDUCE OPERATING COSTS AND PERMIT SOME REDUCTION IN INTERESTS RATES AND PERHAPS ALSO LESS ACTIVE PARTICIPATION OF THE BANKS IN THE OPEN MARKET. THE INCREASED MINIMUM TERM FOR TIME DEPOSITS IS RESULTING IN SIME RENEWED INTEREST AND GROWTH IN INDEXED SAVINGS ACCOUNTS. THE AUTHORITIES ALSO ANNOUNCED A BONUS FOR REGULAR DEPOSITORS IN SAVINGS ACCOUNTS IN A FURTHER STEP TO STIMULATE THE FLOW OF SAVINGS INTO HOUSING FIANCE. THE BNH IS PRESSING THE GOB TO REPURCHASE ORTN WHICH THE BNH ACQUIRED DURING THE EARLIER PERIOD WHEN IT HAD EXCESS RESOURCES BUT CENTRAL BANK SPIKESMAN

HAVE INDICATED THAT THE AUTHORITIES WILL STRONGLY RESIST AND SUCH ACTION BECAUSE IT WOULD HAV DIRECT EXPANSIONARY IMPACT ON LIEQUIDITY. IN FACT, IN ORDER TO REVERSE THE DETIROATION IN THE TERM STRUCTURE OF THE INTERNAL DEBT, THE GOB RECENTLY ANNOUNCED AN INCREASE IN INTEREST RATES ON ORTN FROM 4 TO 6 PERCENT ON 5-YEAR TREASURY BONDS. FINALLY, THE AUTHORITIES HAVE STATED THAT THEIR DRIVE TO DIVERSITY FOREIGN BORROWING INTO BOND MARKETS (PERHAPS TO \$1BILLION IN 1978) IS PROMPTED IN PART BY THE DESIRE TO CAPTURE FOREIGN EXCHANGE THAT NEED NOT BE AUTHOMATICALLY CONVERTED INTO CRUZEIRO BANK DEPOSITS. IT ALSO HAS BEEN SUGGESTED THAT THE GOB WILL STERILIZE FOREIGN LOANS IN 1978 AS IT DID IN 1977 IN ORDER TO REDUCE THE EXPANSIONARY EFFECT OF FOREIGN EXCHANGE INFLOWS. WE BELIEVE CONFIDENTIAL

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THE AUTHORITIES MAY RESORT TO THIS TACTIC BUY ONLY LATE IN THE YEAR IF MONETARY TRENDS ARE VIEWED AS CLEARLY UNSATISFACTORY.

10. EXPECTATIONS FOR 1978 AND BEYOND. THE COMBINATION OF DROUGHT REQUIRING SPECIAL CREDIT AND THE HEAVY FOREIGN BORROWING DUE TO FAVORABLE MARKET CONDITIONS HAS PRESENTED THE BRAZILIAN MONETARY AUTHORITIES WITH A SERIOUS CHALLENGE. THEY MUST ATTEMPT TO CONTROL THE GROWTH IN MONETARY AGGREGATES BU STILL TRY TO AVOID:

- A) FORCING INTEREST RATES TO UNACCEPTABLE LEVELS;
- B) SERIOUSLY DAMPENING THE RECENT UNEXPECTEDLY SHARP RECOVERY IN INDUSTRIAL ACTIVITY; C) FURTHER AGGRAVATING THE INTERNAL PUBLIC DEBT; D) DISCOURAGING LABOR-INTENSIVE HOUSING

CONSTRUCTIONM MINISTER OF FINANCE SIMONSEN AND CENTRAL BANK OFFICIALS HAVE RECENTLY ACKNOWLEDGED THAT EVENTS HAVE MADE THE ORIGINAL MONETARY BUDGET TARGETS UNATTAINABLE. THEY NOW SEE MONEY SUPPLY EXPANSION AND INFLATION OF ABOUT 35 PERCENT AS THEIR MOST OPTIMISTIC REALISTIC OBJECTIVES. WE BELIVE SUCH A PERFORMANCE WOULD BE REASONALBE BUT WOULD NOT BE SURPRISED IF THE PROBLEMS WITH AGRICULTURAL PRODUCTION AND PRESSURES TO STIMULATE HOUSING FINANCE RESULT IN MONETARY GROWTH AND INCREASE IN PRICES IN THE 35 TO 40 PERCENT RANGE. WITH RECOVERY IN AGRICULTURAL OUTPUT IN 1979 AND SUBSEQUENT REDUCTION IN INFLATIONARY PRESSURES IMANATING FROM THE SECTOR, THE MONETARY AUTHORITIES SHOULD HAVE GREATER SUCCESS IN CONTROLLING THE MONETARY AGGREGATES AND GREATER FLEXIBILITY TO CARRY OUT PUBLICALLY STATED INTENTIONS TO SHARPLY REDUCE THE PREVAILING HAAVEY SUBSIDIZATION OF AGRICULTURAL CREDIT. THE IMPLIED IMPROVEMENT IN THE EFFICIENCY OF MARKET ALLOCATION OF RESOURCES WOULD CONTRIBUTE TOWARD REDUCING STRUCTURAL DISTORTIONS WHICH TODAY IMPEDE ATTEMPTS TO REDUCE INFLATION.

SAYRE

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Message Attributes

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Capture Date: 01 jan 1994
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Current Classification: UNCLASSIFIED
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Draft Date: 22 jun 1978
Decaption Date: 01 jan 1960
Decaption Note:
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Handling Restrictions: n/a
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ISecure: 1
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Office: ACTION ARA
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
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TAGS: EFIN, BR
To: STATE
Type: TE
vdkgvwkey: odb://SAS/SAS.dbo.SAS_Docs/16a7bf83-c288-dd11-92da-001cc4696bcc
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